



ViewPoint

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Globalising Value Chains or “Why the shiny bits need the dirty bits”

The prevailing Government policy of “internationalisation” presents the idea that New Zealand can develop a robust and growing economy, even if manufacturing companies send the ‘dirty bits’ of their production process offshore. They promote the view that labour cost differences between New Zealand and low cost countries make the relocation of the ‘dirty bits’ (production) away from New Zealand inevitable, therefore we should simply focus on keeping the ‘shiny bits’ (design, research and development (R&D), marketing and ownership) in New Zealand.

This message is clear in the ‘Advancing Economic Transformation’ Cabinet Paper released in November 2007, where Paragraph 53 says:

“The key challenges arising from international integration are for New Zealand to:

- a. Position itself as an attractive location for investment and skills and for those parts of international supply chains that relate to high-value products and activities and that provide the greatest return (e.g. R&D and design). This includes an imperative to develop more and/or larger internationally successful New Zealand businesses, networks of businesses, and segments of the economy; and
- b. Capture the best return through our businesses being part of international value chains offshore (return profits to New Zealand), through developing new business models of operating internationally (such as investing directly in offshore product and distribution chains), rather than transferring valuable activities offshore.”

Ministry of Economic Development,
http://www.med.govt.nz/templates/MultipageDocumentTOC___32344.aspx

Few would have a problem with the document’s objectives and the recommended actions appear deceptively rational. However, they are constructed around a fundamentally flawed concept that “valuable activities” can be separated without penalty. Internationalisation might work in theory, but the message from New Zealand’s manufacturing sector is clear that at a practical level this will not work.

For global businesses, the interaction between each of their ‘separate’ components has a subtle and pervasive impact on their performance and effectiveness. It is not only important to get all of the elements of the business system right, but also the interconnections between those elements. Much of the literature on internationalisation simply shows the different elements or activities of the business system. Diagrams show different components of the supply chain, Customers – Marketing Research – Development – Product Marketing – Procurement – Production – Distribution – Sales & Promotion – Service, as different blocks. While it is obvious that a global business is not compelled to physically co-locate activities, a superficial analysis can form the view (to some who have no experience in how international business really works) that the individual blocks can be separated to different locations without penalty or risk. This view underestimates the importance of supporting interconnections between functions, which are just as important as the individual components.

The Government promotes the view that labour cost differences make relocation of the ‘dirty bits’ inevitable.

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Good businesses will make decisions about the location of their activities based on both suitability for the activity itself and the effectiveness of interconnections with other elements of the system. There will be tradeoffs. A firm may not seek lower labour costs because it is too important that they can produce new products rapidly, suggesting they should have all their functions in the same place. Alternatively, a company may locate R&D closer to its low cost labour production site or locate product management closer to key end markets. This might compromise the quality of the R&D, but this affect can be outweighed by the importance of the low cost production, the productive use of multiple time zones or some other component of the competitive landscape. The cost and reliability of the supply is also a critical factor of internationalisation. The disruption to supply chains may be a huge strategic risk, and the greater the international interdependence, the worse the effect of even short-term disruption.

Cost and reliability of supply is a critical factor in internationalisation.

In reality wage costs are a fairly minor component of the overall picture that controls the profitability of manufacturing. It is worth noting that a direct labour content of less than 5% of sales is not unusual in high technology products, and exchange rate fluctuations could have five times the impact of the difference in labour rates. Many factors contribute to a country's international competitiveness so the priority for Government must be to maximise the advantages available in the policy framework.

What does this mean for a country like New Zealand?

There is no one size fits all solution regarding the location or value of business activities. What might suit garment manufacturing, will not necessarily suit high technology electronics or other complex products. The strategy for each business will be different but there are some common themes for New Zealand, given the country's attributes of isolated geography and small population.

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A number of our firms now compete globally at a micro level in small markets or in the post processing of our 'primary' outputs. Policies and assistance need to nurture the creation of entire businesses in these areas, rather than trying to prescribe which bits should be encouraged and which bits should be neglected. Even if some businesses do send production offshore, it would make sense for our policies to maintain a neutral or positive bias towards locally based production.

Policy settings need to make it more attractive for innovative business to create wealth in New Zealand through personal incentives, company incentives and national infrastructure. Factors such as broadband, transportation networks and tax incentives for productive activity can encourage activity in New Zealand. This comprehensive approach to policy support will promote the retention of as many of the supply chain components as possible, rather than focusing on individual links of the supply chain. The Government must not seek to pick winners or favour particular supply chain activities, as businesses will determine the profitability of their activities themselves.

Effective policy must provide incentives for winning behaviour.

Effective policy must provide incentives, or at least no disadvantage, for winning behaviour. Investment in research, development, productive activity, skills and capability development and new ventures will all assist in increasing our international competitiveness. Incentives are best delivered through the tax code generally to encourage investment in productive activity rather than in static assets. The support of winning behaviours and monetary policy that secures a stable exchange rate will help mitigate disadvantages of the wage rates. Given such changes, perhaps more companies will keep more of their supply chain in New Zealand.